



Irving Trust

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Financial Markets

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(Noon)

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The Federal Reserve has done a remarkable job of stabilizing the Fed funds rate since the end of the third quarter of 1983. With just a few exceptions, the effective funds rate has ranged between 9 3/8% and 9 1/2%. But as the new year began, the weekly average rate blipped up to 10.06%, not too surprising given end-of-year pressures; except end-of-year pressures were not the dominant force in that rate movement. The Fed made a large forecast error of reserve need in the reserve maintenance period ended Jan. 4, and, as a consequence, the market was left in a reserve deficit (net borrowed) position on Thursday and Friday (Dec. 29 and 30). Such forecast errors can be important determinants of the Fed funds rate in the short term. Moreover, reserve forecasting will move into the spotlight under contemporaneous reserve accounting (CRA), which will begin in February. Let's look at what this means.

The statement period ended Jan. 4 provides a good example of how reserve forecast errors affect the Fed funds rate. We know something about the error committed from the comments made by the Fed at its weekly press conference. Before the statement week began, the Fed, as it usually does, crafted a series of forecasts for the major reserve factors. For several factors (currency in circulation, Treasury balances at the Fed, and float), the forecast errors all proved to be in the same direction. They amounted to a forecast of reserve need that was about \$1.4 billion less than the needs that ultimately arose. One large error did work in the other direction, leaving the net forecast error at about \$1.2 billion on a weekly average basis. But as the period unfolded, the Fed realized an error existed. It executed RPs to add liquidity. Still, these efforts fell short, and reserves were drained beyond what the Fed had anticipated. This explains why the average net borrowed position for the first six days of the week was \$1.2 billion--and the pressure on the funds rate.

From this experience we can learn something about how CRA will affect the mechanics of the Fed funds market. First, realize that right now, each bank knows its own reserve needs for the week; the Fed knows the market's reserve requirement early in the period; and banks try to guess what the Fed knows to anticipate its open market operations. Under CRA, neither banks nor the Fed will be sure of their respective reserve needs. Banks also will be trying to guess what the Fed itself is guessing! Yet the Fed might not forecast reserve needs accurately. This situation clearly results in a marketplace with a higher degree of uncertainty. The good news is that the expanded two-week reserve maintenance period under CRA should lead to a greater stability in week-to-week reserve requirements. The bad news is that banks' behavior might change, making other elements that absorb reserves more difficult to forecast.

On balance, these factors should not have a great impact on the Fed funds rate. Were the Fed still following a strict nonborrowed reserves path as in 1980-1982, the effect of CRA would be more substantial. But given that the Fed is stabilizing the funds rate, we should expect the Fed to rely on the rate more as an indicator of reserve need and to act to offset undesired pressures. However, the Fed will find that the heightened uncertainty may keep the markets more nervous than normal and that the Fed's ability to fine-tune will probably be impaired.

Robert A. Brusca



	1/13/84 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	11.00%	11.00%	11.00%
Effective since	8/8/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	8.50
Federal Funds	9.31	9.38	8.38
Repurchase Agreements	9.20	9.38	8.38
U.S. Treasury Issues			
Bills			
3 months	9.11	9.25	7.92
6 months	9.47	9.67	8.08
1 year	9.76	9.96	8.36
Coupons			
2 years	10.58	10.75	9.10
4 years	11.14	11.31	9.60
7 years	11.57	11.71	10.13
10 years	11.64	11.77	10.24
Long Bond	11.71	11.85	10.40
Negotiable Certificates of Deposit-Secondary Market			
1 month	9.30	9.38	8.10
3 months	9.35	9.45	8.15
6 months	9.50	9.68	8.25
1 year	10.00	10.10	8.65
Banker's Acceptances			
1 month	9.25	9.42	8.05
3 months	9.35	9.47	8.10
6 months	9.50	9.69	8.30
Eurodollar Deposits			
1 month	9.69	9.69	8.75
2 months	9.81	9.88	8.75
3 months	9.88	9.94	8.75
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	9.34	9.45	8.00
1 month	9.35	9.50	8.17
3 months	9.49	9.55	8.41
Bank Holding Companies			
1 month	9.07	9.19	7.91
Dealer Placed:			
3 months	9.58	9.60	8.32
New AA Corporate Utility Bond	12.75	13.00	12.35
Tax Exempt			
6 month Project Notes	5.35	5.45	4.40
1 year AAA Bond	5.35	5.60	4.50
5 year AAA Bond	7.20	7.15	6.15
20 year AAA Bond	9.10	9.20	8.60

This information represents prevailing market yields.

It should not be construed as an offering.

All yields are on the offered side of the market.

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